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April 14, 2017

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

We appreciate the opportunity to respond to your request for proposals that will promote economic growth. The Clearing House is owned by 25 banks that provide commercial banking services on a regional or national basis and in some cases are also active participants in global capital markets as broker-dealers and custodians. Our owner banks fund more than 40 percent of the nation's business loans, including almost $200 billion in small business loans, and more than 75 percent of loans to households.

Smart financial regulation must serve goals that are frequently in tension: ensuring the safety and soundness of banks that take insured deposits; preventing threats to financial stability arising either from banks or non-banks; and allowing banks and other financial institutions to fund economic growth by making informed judgments about credit allocation. Although the financial crisis made clear the importance of these goals, the U.S. federal banking agencies have since focused substantially more on limiting risk at banks and their non-bank affiliates than they have on promoting economic growth.

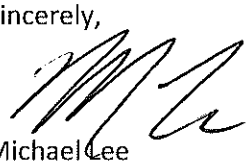
As a result, the current financial regulatory environment suffers from two key weaknesses: (i) seemingly insufficient attention to financial regulation's impact on banks' ability to support economic growth, and (ii) insufficient transparency, accountability, and analytical rigor in the development and enforcement of rules that have a tremendous downstream impact on our financial system and the economy it serves. We appreciate the Committee's focus on addressing these problems in order to "promote economic growth" and "enable consumers, market participants and financial companies to better participate in the economy." As a first step in that effort, we encourage the Committee to work with the Administration to identify and confirm banking agency officials who appreciate the need to strike this balance and can produce a regulatory environment that better balances these goals.

In addition, we want to express the importance of identifying existing capital requirements and other prudential rules that can be better tailored to different risk profiles and business models. We believe opportunities for such tailoring exist across the broad spectrum of bank types and business models, including community banks, regional banks of various sizes, G-SIBs, custody banks, and the U.S. operations of foreign banks. And indeed, to the extent that a key objective of that exercise is to ensure that U.S. banks are in a position to safely and efficiently meet the needs of their customers and the U.S. economy as a whole, it is crucial that immediate steps be taken to rationalize and better tailor the regulatory regime across the entire U.S. banking system.

Below are recommendations that could be implemented legislatively to produce economic growth and improve the financial regulatory system. We believe that your stated goals are achievable without abandoning the many improvements that have been made in supervision and regulation since the financial crisis.

We look forward to continued work with you and the members of the Committee on these important issues. If you have any questions, please contact the undersigned by phone at 202.649.4617 or by email at mike.lee@theclearinghouse.org.

Sincerely,



Michael Lee
MD and Head of Government Affairs
The Clearing House Association L.L.C.

Promoting Economic Growth

The financial crisis demonstrated that robust capital levels are essential to the resiliency of both individual banks and the larger financial system, and banks have responded by dramatically increasing both the quantity and quality of their capital and liquidity positions. Increasingly, however, how that capital and liquidity are deployed – and thus what businesses receive funding – is being determined by regulators rather than bankers.

Improve the implementation of stress testing

Banks have traditionally made lending and market decisions based on their own assessment of the economic risk, allocating capital accordingly. Regulatory capital requirements ensured a cushion against unexpected loss, but were set at levels that did not drive a bank's decision on whom to fund. But increasingly, it is the Basel Committee of global regulators and the U.S. banking agencies that effectively dictate how banks must allocate their capital across a wide range of assets, and thus what businesses they enter, emphasize or exit.

A common misperception is that bank capital and liquidity standards are value neutral – that is, that the only consequences of higher capital requirements are lower returns on equity for bank investors or marginally higher prices across the board for bank customers. This is simply not the case. In fact, banks seeking an acceptable return on equity for their shareholders will seek to optimize their use of capital, identifying activities that are drawing the highest capital and liquidity charges relative to their risk and return, which may lead to exiting or scaling back of certain activities, or in some cases, significant repricing of such activities.

A few academic papers have recently suggested that banks with a greater amount of capital tend to lend more as a result of lower funding costs. This evidence has been used to support further increases in capital requirements worldwide, including the proposed inclusion of the global systemically important banks (GSIB) capital surcharge in U.S. stress tests. Two recent academic papers supporting the view that higher capital levels lead to an expansion of loan growth are Gambacorta and Shin (2016)[1] and Michelange and Sette (2016)[2]. For instance, Gambacorta and Shin (2016) find that a 1 percentage point increase in the equity-to-total assets ratio is associated with a 0.6 percentage point increase in annual loan growth.

Recent research conducted by The Clearing House, however, demonstrates that the positive relationship between bank capitalization and the growth of lending is driven by the amount of capital held in excess of minimum capital requirements, an amount we refer to as the "capital surplus." That is, our results show that banks with a higher capital surplus tend to lend more. In contrast, we find that an increase in [minimum] capital requirements leads to a decrease in loan growth. Specifically, we find that a 1 percentage point increase in capital requirements is associated with a 0.7 percentage point reduction in loan growth. These results have important implications for the calculation of the costs and benefits of

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1 http://www.bis.org/publ/work558.htm

2 http://www.bis.org/publ/work557.pdf

higher capital requirements and other regulations for banks. An increase in capital requirements, such as the incorporation of the GSIB surcharge in Fed's stress tests, would lower loan growth and reduce economic growth. Conversely, an increase in the surplus of capital either because capital requirements had been reduced or because banks earned and retained solid profits would lead to more lending and boost growth.[3]

Additional Clearing House research presents evidence that the supply of residential mortgage loans, credit card loans and small business loans has been significantly restricted by the new financial regulations that have been introduced in recent years. Moreover, bank-dependent borrowers – such as households and small businesses – are likely to be the types of borrowers most impacted by the increase in banks' capital requirements since the alternative sources of lending provided by nonbanks and online lenders are quite expensive.[4]

As the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) is the binding capital requirement for large banks, banks will tend to shift lending away from sectors with higher implicit capital requirements under CCAR – that is, sectors that are disfavored by the severe macroeconomic scenarios in the tests – and toward sectors with lower implicit capital requirements. In other words, the CCAR exercise has substantial asset allocation power, and the Federal Reserve's choices with respect to CCAR can and do have a strong effect on the availability of credit.

A recent research note issued by the TCH Research Department shows just how powerful these credit allocation effects of CCAR can be.[5] The results of that research show that the Federal Reserve's CCAR stress test is imposing dramatically higher capital requirements on certain asset classes – most notably, small business loans and residential mortgages – than bank internal (approved by the Federal Reserve) models and Basel standardized models. For some asset classes – for example, commercial real estate – the Federal Reserve's CCAR stress test produces results similar to the results of the banks' modeled results, and lower capital requirements relative to the relevant standardized model.

By imposing higher capital requirements on loans to small businesses and mortgage loans, stress tests are likely curtailing credit availability to the types of borrowers that lack alternative sources of finance. Both small businesses and the housing sector perform a very important role in the U.S. economy. For instance, small businesses account for more than 40 percent of private nonfarm gross domestic product and the formation of new businesses contribute substantially for the creation of new jobs; large banks originate about half of those loans by dollar amount and substantially more than half by number. Thus, by curtailing credit to these two key sectors of the U.S. economy, stress tests may be having an adverse impact on economic growth and contributing to the widening of income inequality among households. Conversely, our results also suggest that stress tests impose lower capital requirements for commercial

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3 Bank Capitalization and Loan Growth: https://www.theclearinghouse.org/-/media/files/research%20notes/20161216-bank-capitalization-and-loan-growth.pdf?la=en

4 Is Tighter Bank Regulation Restricting Loan Growth?: https://www.theclearinghouse.org/eighteen53-blog/2016/december/01-loan-growth

5 The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test: https://www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf

real estate and consumer loans than other capital standards; however, this outcome may reflect large banks' concentration in the lower-risk end of the commercial real estate lending spectrum and still tight consumer lending standards.

Given the substantial economic importance and impact of the CCAR regime, one would expect that its key elements would have been subject to a robust and transparent public debate pursuant to the Administrative Procedure Act. But this is not at all the case: the most important drivers of CCAR results are decided by the Federal Reserve without public input and indeed, in some cases, without public access to the decision itself. First, as noted, although the Federal Reserve does at least publish its annual stress scenarios, it does so only in final form, without soliciting public feedback on those scenarios. Second, the Federal Reserve uses its own internal models to estimate stressed credit losses and net revenues but provides virtually no detail regarding the statistical specifications of these models. Nor does it disclose any data on the actual performance of the models it uses in stress testing.

It is also worth noting that although stress-testing is now a standard supervisory practice globally, the U.S. CCAR exercise is unique in its opacity. Most notably, under both the Bank of England and the European Banking Authority stress testing regimes, models used by participating banks play a key role. In particular, in these jurisdictions banks can take into account their own past loss experience and incorporate differences in business models, which likely results in more accurate bank-specific projections of post-stress capital ratios.

Recommendations for Congressional Action

To address these and other existing problems with CCAR, we recommend the following changes:

- Subject the annual stress test scenarios to a 30-day notice and comment period under the Administrative Procedure Act;
- Require harmonization to correct counterfactual and incorrect assumptions about how banks would behave in a crisis (e.g., continued dividends and repurchases under severe stress which may also conflict with other capital rules such as the capital conservation buffer);
- Use banks' own DFAST results to estimate stress losses for purposes of the CCAR quantitative assessment;
- Restrict use of the Federal Reserve's own models to a supervisory assessment; and disclose those models to the public to benefit from peer review; and
- Eliminate CCAR's qualitative assessment for all banks, returning to the traditional examination process.

We note that pursuant to these reforms, the Federal Reserve would continue to engage in modeling as part of CCAR. Such modeling would inform its oversight of the banks' own models. If a bank's own models were deemed insufficient, the Federal Reserve's model would be offered as evidence in issuing a capital directive or other enforcement action.

Significantly, under this approach, because there would be no concern that all banks would allocate credit according to the Federal Reserve's models (gaming), there would be no reason for the Federal

Reserve's models to remain secret. They could then benefit from peer review by the academic community in a way that bank models, which are proprietary, cannot.

Enabling Market Participants and Financial Companies to Better Participate in the Economy

In addition to the recommendation on CCAR, there are several other areas the Committee could address in order to meet the goal of enabling market participants to better participate in the economy. While there are many areas that Congress should address, we specifically address two of these important areas below.

Improve the Federal Reserve and FDIC living wills process

Title I of Dodd-Frank requires large banks to construct a "pre-packaged" bankruptcy plan – or "living will" - under the Bankruptcy Code, and requires regulators to review the credibility of that plan. This requirement is an important and altogether appropriate one. The required review, however, has been translated into a shadow regulatory regime, almost entirely opaque, and with real economic consequences. While any regulatory review of a bankruptcy plan will necessarily have subjective elements, and require some element of confidentiality, many requirements imposed under the living will process are unnecessary and even counterproductive under the resolution regime accepted by those same regulators.

Most U.S. G-SIBs have based their living will on the single-point-of-entry (SPOE) resolution strategy.[6] Under the SPOE strategy, all the losses across a U.S. G-SIB would be absorbed by shareholders and creditors of its parent holding company, which would fail and be put into a Chapter 11 bankruptcy or an FDIC receivership under Title II of Dodd-Frank. The two principal benefits of this strategy are (i) making it legally and operationally feasible to impose losses on holding company debt holders, thereby vastly expanding the loss absorbency of the relevant banks, and (ii) allowing the material operating subsidiaries to remain open, thereby minimizing the systemic consequences of a large banking organization failure.

The Federal Reserve has made SPOE a viable option through its Total Loss Absorbing Capacity Rule, which requires U.S G-SIBs to hold massive amounts of capital or long-term debt at the top-tier holding company level.[7] Under the rule, each U.S. G-SIB is required to maintain minimum total loss absorbing

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6 All but one of the U.S. G-SIBs have now publicly adopted the SPOE bail-in strategy as their preferred resolution strategy under the U.S. Bankruptcy Code and are otherwise expected to be resolved with an SPOE strategy under Title II of the Dodd-Frank Act. These U.S. G-SIBs have adopted the SPOE strategy in their living will plans: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup Inc.; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; and State Street Corporation. [note that footnote font is different from main text]

7 The Federal Reserve's TLAC rule also requires the U.S. IHCs of non-U.S. G-SIBs to maintain substantial amounts of internal TLAC that can be utilized to recapitalize the U.S. IHCs should they become troubled. See Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266 (Jan. 24, 2017).

capacity equal to 21.5 percent to 23 percent of its total risk-weighted assets, and 9.5 percent of its total assets. The eight U.S. G-SIBs alone are expected to maintain, on an aggregate basis, more than $1.5 trillion in total loss absorbing capacity. The scale of this reform has not been widely appreciated. Furthermore, a protocol entered into among the major dealer G-SIBs, the ISDA 2015 Universal Resolution Stay Protocol, prevents close-out of derivatives at the subsidiary level based on a holding company bankruptcy, thereby eliminating the largest possible source of systemic instability (witness, Lehman Brothers) from a holding company bankruptcy.[8] In order to extend this systemic protection beyond dealer bank transactions, the Federal Reserve, FDIC and OCC have proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with all of their counterparties, and we urge them to finalize that rule promptly.[9]

Despite the fact that these banks have credible living wills based on an SPOE strategy, the FDIC and Federal Reserve are imposing massive costs on some firms – and their customers – by effectively requiring them to structure themselves almost as if the SPOE strategy did not exist. In other words, the regulators seem to be requiring substantial liquidity and capital to be pre-positioned – and therefore, trapped – at material subsidiaries on the assumption that each such subsidiary will be resolved independently. This is the antithesis of the regulators' SPOE strategy as outlined in the approved plans.

By way of example, the most recent living will guidance issued in April 2016 requires each of the largest U.S. banking organizations to determine its Resolution Liquidity Adequacy and Positioning, or RLAP, as well as its Resolution Liquidity Execution Need, or RLEN.[10] RLAP requires the firm to estimate standalone liquidity needs of each material subsidiary for 30 days of stress, and ensure liquidity is either pre-positioned in the subsidiary or otherwise available at the parent as HQLA to meet deficits. RLEN requires the firm to further account for the estimated liquidity needed post-bankruptcy filing to support the surviving or wind-down subsidiaries. The guidance states that firms must assume that a net liquidity surplus in one material subsidiary cannot be moved to meet liquidity deficits at another material subsidiary. The guidance imposes similar requirements with respect to pre-positioning of loss absorbing capital resources at material subsidiaries.

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8 International Swaps and Derivatives Association ("ISDA"), Adhering Parties: ISDA 2015 Universal Resolution Stay Protocol (last updated June. 17, 2016), available at https://www2.isda.org/functional-areas/protocol-management/protocol/22

9 Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (proposed May 11, 2016) (the Federal Reserve's proposal); Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (proposed Aug. 19, 2016) (the OCC's proposal); and Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 74,326 (proposed Oct. 26, 2016) (the FDIC's proposal).

10 Similar guidance was issued just last week to the largest foreign banks operating in the United States.

Not only are these overly prescriptive liquidity and capital pre-positioning requirements antithetical to the underlying premise of the SPOE strategy, they also interfere with, and indeed may even supersede, other existing liquidity regulations, at high cost to the efficiency with which firms operate, and the efficiency with which they can serve their clients. The appropriate remedy here is clear: any firm using the single-point-of-entry resolution strategy and in compliance with the TLAC requirement for holding company loss absorbency, the living will process should not include any incremental liquidity or capital requirement at the operating subsidiary level.

Finally, the agencies take an extraordinarily broad, counterfactual view of what constitutes a "material entity" at which both capital and liquidity must be prepositioned for resolution purposes. The agencies generally define a material entity to include any subsidiary that is significant to the activities of a critical operation or core business line of the firm. But this definition is far too broad. At a minimum, a material entity for this purpose should include only entities whose failure would impose systemic consequences or result in a material loss to the organization's insured bank affiliate.

Most remarkably, none of these requirements has been subject to public notice and comment (or submitted to the Congress under the Congressional Review Act), although they meet every criterion for a rule. RLEN and RLAP are creations of the supervisory process, and have no grounding in law or regulation. Moreover, the details of the requirements are designated as "confidential supervisory information," and thus any public complaint about their contents is, in the view of the agencies, a federal crime.

If notice and public comment were permitted, we would argue that the extraordinary costs of entity-level requirements are unwarranted given the absence of any benefit. Furthermore, we believe that such requirements are actually counterproductive to resolution: trapped liquidity cannot be used by the holding company in recovery or the resolver in resolution to be sent to the entity actually experiencing trouble in the way that holding company liquidity can.

Recommendations for Congressional Action

- The Federal Reserve and FDIC should be required to solicit public comment on any instruction or mandate, including any liquidity requirements that are applicable to two or more firms.
- Congress should require GAO to review compliance with this action.
- All firms should be moved to a three-year planning cycle.

CAMELS Ratings

The CAMELS rating system was adopted in 1979, at a time when there was no capital regulation, no liquidity regulation, and no stress testing regulation – in other words, at a time when bank supervision was necessarily highly subjective. That system is now hopelessly out of date. Detailed capital, liquidity and other rules have been expressly designed and carefully calibrated to evaluate the key components of the CAMELS ratings: obviously, capital and liquidity, and less obviously, earnings and asset quality, which are evaluated through stress testing for certain banks. The CAMELS regime thus is now clearly outmoded in design, and has also become punitive and arbitrary in practice.

The CAMELS system evaluates a bank across six categories – capital, asset quality, management, earnings, liquidity, and sensitivity to market risk, especially interest rate risk – and assigns a composite rating, all on a scale of 1 (best) to 5. Except for the addition of the "S" component, the CAMELS standards have not been materially updated in the almost 40 years since their adoption – not since adoption of the Basel Accord on capital in 1988, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014 .

Thus, for example, the standards that examiners apply in deciding the Capital component of the rating do not include consideration of any post-1978 regulatory capital standards – or any market indicators, which also have grown in sophistication over the past few decades. Rather, they speak vaguely of "the ability of management to address emerging needs for additional capital" and "balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities." Similarly, for the Liquidity component, compliance with the Federal Reserve's self-titled "*Comprehensive* Liquidity Analysis and Review" is not mentioned in the standards; instead, there are vague conditions such as "access to money markets and other sources of funding" and "the trend and stability of deposits."

In a speech in 2013, the Federal Reserve Board noted approvingly this state of affairs:

If you look at the criteria for rating capital adequacy under the banking agencies' CAMELS rating system for banks, and under the Federal Reserve's RFI rating system for bank holding companies, you will actually see very few references to minimum regulatory capital. Instead, the focus is on maintaining capital that is commensurate with the overall risk profile of the bank, not just credit risk. This requires both management and the supervisor to have an effective understanding of the banking organization's risk profile, which is central to our supervisory program.[11]

This statement is difficult to fathom. The stated purpose of CCAR, DFAST, Basel III, and even the standardized approaches to capital adequacy is exactly to ensure that capital is "commensurate with the overall risk profile of the bank."[12] The Federal Reserve has, on numerous occasions, touted CCAR – which, as indicated by its very title, is intended to be a "comprehensive" assessment as a program through which "the Federal Reserve assesses the overall capital adequacy of the firms, including evaluations of whether each firm's capital provides an adequate buffer for the losses that would be incurred during the stress scenarios, whether its risk management and capital planning processes are appropriately well-developed and governed, and how its plans to distribute capital through dividends or share repurchases could affect its ability to remain a viable financial intermediary in the hypothesized

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11 *See* Sarah Bloom Raskin, Let's Move Forward: The Case for Timely Implementation of Revised Capital Rules (June 6, 2013), available at www.federalreserve.gov/newsevents/speech/raskin20130606a.pdf.

12 Indeed, the Basel Committee has explained that one of the primary purposes and functions of the Basel III capital reforms was to respond to "the need to strengthen the risk coverage of the capital framework" and ensure that all types of risks were reflected and addressed in the bank capital framework. *See* Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (rev. June 2011) at 3.

scenarios."[13] Thus, in no sense whatsoever are those capital standards limited to "just credit risk." While there is a standardized approach to capital solely devoted to credit risk, there are also frameworks for market risk and operational risk for banks for which they are relevant. If there is a part of the "banking organization's risk profile" that these risk-based capital measures are missing, no regulator has ever identified them.[14]

Indeed, one further weakness of the CAMELS system is that it treats each factor as independent, when in fact they are intensely interrelated. Consider the Federal Reserve's CCAR stress test, which is effectively a measure of capital adequacy. Both the asset quality and earnings of the firm drive that capital requirement. So, a firm with more risky loans and more capital can perform as well as a firm with less risky loans and less capital. The "A" in CAMELS, taken singularly and literally, suggests that a bank that takes more risk would receive a lower score than one that takes less risk. But, as modern capital measures and stress testing recognize, the reality is far more complex, and demand an assessment that is holistic, not compartmentalized.

Over time, however, CAMELS ratings have become progressively more arbitrary, subjective and compliance focused. Perhaps because capital, liquidity and other factors are now regulated directly and specifically, the CAMELS rating has come to focus myopically on the one highly subjective factor: management. Various "unwritten rules" reportedly have been adopted:

- Any compliance problem resulting in enforcement action, regardless of its materiality, results in a downgrade of Management;
- In terms of ratings, "2" is the new "1," and "3" is the new "2." Thus any downgrade in management rating will be from a "2" to a "3."
- An institution with a "3" for Management cannot have better than a "3" Composite rating.

This is not to say that there cannot be cases where a bank that is deemed well-capitalized under 35-plus different capital tests could not in theory still require more capital. It is to say, though, that an examiner making a judgment that those 35-plus tests have proven insufficient with respect to the bank under supervision should face a high bar and, more importantly, have to produce an actual, reasoned, and easily appealable analysis as to why. Nothing can be further from the truth today.

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13 Governor Daniel K. Tarullo, Next Steps in the Evolution of Stress Testing (September 26, 2016), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm, *See also* Tim P. Clark and Lisa H. Ryu, CCAR and Stress Testing as Complementary Supervisory Tools, *available at* www.federalreserve.gov/bankinforeg/ccar-and-stress-testing-as-complementary-supervisory-tools.htm (noting that "[t]ogether [supervisory stress tests and CCAR] allow supervisors to move beyond more traditional static analysis of capital ratios and to conduct a forward-looking evaluation of capital adequacy that incorporates both quantitative analysis and qualitative reviews of large BHCs' capital planning and positions").

14 It is worth noting that if the sole capital requirement were a leverage ratio, which treats all assets as having the same risk, then a subjective supervisory assessment of capital would be necessary. But that is manifestly not the case currently.

The stakes for a CAMELS rating were raised significantly in 1999, when the Gramm-Leach-Bliley Act conditioned the ability to continue as a financial holding company on maintaining a CAMELS 1 or 2 rating. (Financial holding companies are those that may exercise certain non-bank financial activities.) Prior to 1999, a supervisor with genuine safety and soundness concerns was required to use the options laid out for it by Congress in statute: namely, the issuance of an order to correct an unsafe and unsound condition or practice – an enforcement action under 12 U.S.C. § 1818 of the FDI Act—or the issuance of a capital directive under 12 U.S.C. § 3909(d)), promulgated under the International Lending Supervision Act of 1983. Both types of orders came with a meaningful ability for the institution to appeal, including a notice of charges and an opportunity for a hearing before an Administrative Law Judge. With enactment of the Gramm-Leach-Bliley Act, both those processes became dead letters with respect to financial holding companies. Regulators had no need to draft a formal notice of charges, or put their allegations to the test in front of a neutral arbiter, when all they had to do was threaten a CAMELS downgrade, or actually execute a CAMELS downgrade.

While only larger banks tend to be part of a financial holding company, mid-sized and small banks are effectively subject to the same restrictions. Regulators call this the "penalty box," whereby all expansion is halted until compliance violations – generally minor and relevant to only a small part of the organization – stop all expansion for years at a time.

Thus, the CAMELS system has changed from an overall evaluation of the safety and soundness of an institution to an evaluation of routine compliance matters and the readiness with which management accedes to examiner criticism – all as the consequences of a low rating have risen dramatically. That is not to say that compliance matters are not important; it is to say that they should not pollute a system designed for an altogether different, very important safety and soundness purpose, and should not be exempt from legally required procedural requirements. Nothing better explains the current imbalance in the supervision and regulation process than these changes to the CAMELS regime.

Relatedly, other supervisory "unwritten rules" have grown up alongside the CAMELS process. For example, expansion is prohibited so long as any consent order is pending. Consent orders cannot be lifted for at least two years, and generally significantly longer. Consent orders and more informal enforcement action often require a bank to hire independent consultants to perform the work of the bank (and the examiner), which further lengthens the remediation process.

The results of this new supervisory regime are significant:

- Banks of all sizes, but particularly mid-sized banks, have been blocked from branching or merging to meet their customers' needs.
- Bank technology budgets often are devoted primarily, not to innovation, but rather to redressing frequently immaterial compliance concerns.
- Board and management time is diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns, and engaging in frequent meetings with examiners, to ensure that they are fully satisfied.

The unfortunate truth is that examiners have three powerful reasons to ignore market data and regulatory capital ratios in assigning CAMELS ratings. The first reason is to remain relevant. Second, to gain leverage over the firms they examine. Third, to avoid an accusation – either now or in the future – that they were either inattentive or captive. Those are powerful motivations, and perfectly understandable ones. Of course, it is exactly why the CAMELS regime must be upgraded to include clear, objective standards for evaluation.

Given the potential impact of a CAMELS rating, one might expect banks to appeal adverse ratings frequently. That does not happen, however, for two reasons. First, every banker and bank counsel is taught that "examiners have long memories," so retaliation is expected as the norm.[15] Second, appeals are made to the same agency that assigned the rating. For example, at the Federal Reserve, the ultimate arbiter in an appeal is a designated Federal Reserve Board Governor, while at the FDIC, appeals are ultimately decided by the agency's Supervision Appeals Review Committee, which consists of three voting members: one inside FDIC Board member, and one deputy or special assistant to each of the inside FDIC Board members who are not designated as the SARC Chairperson. In addition, the FDIC's General Counsel serves as a non-voting member of the Committee.

Law Professor Julie Andersen Hill published an article in 2014 in which she analyzed the appeals process at each of the three federal banking agencies"[16] Professor Hill explains that the processes and standards governing appeals are far from transparent and that the standards for reviewing appeals differ across the agencies (and with respect to the Federal Reserve, among individual Federal Reserve Banks themselves), leading her to conclude that the appeals process at each agency is "a dysfunctional and seldom used system."[17] Further, for those few banks that attempt to appeal a supervisory decision, Professor Hill concluded, based on the data that she was able to obtain, that banks seldom win their appeals.[18] Thus, the appeals system is rife with disincentives for financial institutions to pursue remedies against supervisory actions with which they disagree, and it is not surprising how few appeals there are. Indeed, there are so few that the agencies do not even keep good records of them. For example, when Professor Hill attempted to obtain the records of banks' appeals from the Federal Reserve under FOIA, the agency advised that there were no records available for any appeals between 1995 and 2000.[19]

Interestingly, the CAMELS rating system has no reference in statute. It was issued by the FFIEC – the umbrella group through which the banking agencies issue call reports and other common forms – pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978,

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15 Indeed, in recognition of this tendency to retaliate, the agencies have adopted internal policies criticizing examiner retaliation against institutions for pursuing supervisory appeals.

16 "When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations," by Julie Andersen Hill, Associate Professor of Law, University of Alabama School of Law (2014) at 14, *available at* www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_AndersonHill.pdf

17 *Id.* at 4.

18 *Id.* at 4.

19 *Id.* at 4, 64.

which provides only that the FFIEC "shall establish uniform principles and standards and report forms for the examination of financial institutions which shall be applied by the Federal financial institutions regulatory agencies." It seems difficult to read "uniform principles and standards" to convey a numerical grading system.

Recommendations for Congressional Action

We strongly recommend that Congress repeal the CAMELS requirement for financial holding company status under the Gramm-Leach-Bliley Act and replace it with a requirement allowing the regulators to disqualify a bank from financial holding company status on managerial grounds – after notice and the right to a hearing. We also recommend that the current CAMELS system with an entirely different construct, after a notice and comment process under the Administrative Procedure Act. One potential model is the system that the Federal Reserve uses to evaluate bank holding companies.[20]

In the interim, existing guidance should be amended to modernize the CAMELS rating system, as follows:

- A bank that is well capitalized under all relevant capital requirements, including its parent holding company's passage of its most recent CCAR/DFAST stress test if applicable, should be presumed to be "1" rated for purposes of its Capital rating.
- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be "1" rated for purposes of its Asset Quality rating.
- A bank's Management rating shall reflect primarily the risk management practices of the bank, focused on those practices that have a *material* effect on its *safety and soundness*.
- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be "1" rated for purposes of its Earnings rating.
- A bank that is in compliance with the Liquidity Coverage Ratio, if applicable, should be presumed to be "1" rated with respect to Liquidity.

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20 Under this "RFI/C(D)" rating system, BHCs generally are assigned individual component ratings for risk management (R), financial condition (F), and impact (I) of nondepository entities on subsidiary depository institutions. The risk management component is supported by individual subcomponent ratings for board and senior management oversight; policies, procedures, and limits; risk monitoring and management and information systems; and internal controls. The financial condition rating is supported by individual subcomponent ratings for capital adequacy, asset quality, earnings, and liquidity. An additional component rating is assigned to generally reflect the condition of any depository institution subsidiaries (D), as determined by the primary supervisor(s) of those subsidiaries. An overall composite rating (C) is assigned based on an overall evaluation of a BHC's managerial and financial condition and an assessment of potential future risk to its subsidiary depository institution(s). A simplified version of the RFI rating system that includes only the risk management component and a composite rating is applied to noncomplex BHCs with assets of $1 billion or less. Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern, whereas a 5 numeric rating indicates the lowest rating, weakest performance, and the highest degree of supervisory concern. *See* Federal Reserve Supervisory Letter SR 04-18, "Bank Holding Company Rating System," (December 6, 2004), *available at* www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm .

- A bank's composite rating should be an average of each of its component ratings, weighted equally.
- Compliance with laws that do not directly affect safety and soundness – including the Bank Secrecy Act and consumer laws – should be dealt with under separate and existing enforcement authority or the Compliance rating.

Consistent with these changes, Congress should ensure that the banking agencies adhere to the statutory standard prescribed by Congress in evaluating acquisitions under the Bank Holding Company Act, mergers under the Bank Merger Act, and branching applications under the International Banking Act, and not pursuant to additional hurdles created by supervisory fiat. The statutory standards here are clear.[21] Applications should be processed promptly according to those criteria, and arbitrary CAMELS requirements and other supervisory creations should not be imposed.

We also strongly recommend that the Federal Reserve publish for notice and public comment, and submit any final rule to the Congress pursuant to the Congressional Review Act, the contents of its Supervisory Letter 14-2. That guidance, which the Federal Reserve has clearly treated as a regulation, includes a wide range of supervisory limits and conditions on bank expansion that have no basis in law.

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[21] The Bank Holding Company Act prohibits the Board from approving any acquisitions that would result in a monopoly or substantially lessen competition and requires the Board to consider, among other things, the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant company or companies in combating money laundering, and whether the transaction would result in greater or more concentrated risks to the stability of the United States banking or financial system. *See* 12 U.S.C. § 1842(c). Similarly, the Bank Merger Act provides that the responsible agency shall not approve any proposed merger transaction that would result in a monopoly or substantially lessen competition and requires such agency to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant institutions in combating money laundering, and the risk to the stability of the United States banking or financial system. *See* 12. U.S.C. § 1828(c). Finally, in considering an application by a foreign bank to establish a federal branch or agency in any state outside its home state, as set forth in 12 U.S.C. § 3103(a)(3), the Comptroller of the Currency must determine that the foreign bank's financial resources, including the capital level of the bank, are equivalent to those required for a domestic bank to be approved for branching under 12 U.S.C. § 36 and 12 U.S.C. § 1831u, which sets forth the criteria that must be considered in evaluating interstate bank mergers. In addition, the OCC must consider the factors that must be considered in evaluating interstate bank merger applications under 12 U.S.C. § 1831u, including consideration of the most recent CRA evaluation of any bank which would be an affiliate of the resulting bank and the record of compliance of any applicant bank with applicable State community reinvestment laws. In addition, each bank involved in the transaction must be adequately capitalized, and the resulting bank must be well capitalized and well managed upon the consummation of the transaction. The Comptroller also must consider the same factors that the Board must consider in evaluating an application for the establishment of a foreign bank office in the United States under the financial and managerial resources of the foreign bank, including the bank's experience and capacity to engage in international banking. *See* 12 U.S.C. 3105(d).